

Abrogating the Right and Duty of Liability Insurers to Defend their Insureds: The Case for Separating the Obligation to Indemnify from the Defense of Insureds

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Liability insurance obligates the insurer to provide indemnification, up to the coverage limits, for sums that insureds are legally obligated to pay as damages resulting from accidents to which the insurance applies. It is a relatively new form of insurance, first marketed in the late nineteenth century.¹ However, in the course of approximately one hundred years, there has been an incredibly rapid expansion in the acquisition of liability insurance throughout the United States. Today, millions of liability insurance policies provide both enterprises and individuals with coverage for risks incident to many different types of activities.²

In most cases when an occurrence covered by liability insurance results in damages to a person or to property, the insurer works out a settlement on behalf of the insured that serves to terminate the matter. Nevertheless, there are thousands of instances every year in which an injured party's claim against an insured develops into a lawsuit.

Liability insurance policies generally include provisions entitling — and in many instances obligating — the insurance company to provide a defense for insureds when a claim or a lawsuit asserts that the injuries were the result of an occurrence which is within the scope of the coverage.³ Insurers usually view these provisions as empowering the insurer to select the attorney who will serve as defense counsel, to arrange the fees that will be paid to that attorney, to instruct the attorney about other defense expenses that the insurer will pay,⁴

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1. For example, liability insurance for business firms was introduced around 1890. See S. HUEBNER, K. BLACK JR., & R. CLINE, *PROPERTY AND LIABILITY INSURANCE* 353 (3d ed. 1982). At that time employers sought to arrange indemnification for tort claims being asserted by injured employees. Liability insurance for motorists began to be available as use of automobiles rapidly expanded in the early years of the twentieth century. In general, the acquisition of various types of liability coverage has accompanied urbanization and increasing levels of commercial activity in the United States.

2. The breadth and diversity of various types of liability insurance is indicated by even a very abridged list of the types of coverage currently being marketed, which include (1) accountants' liability, (2) advertising liability, (3) architects' liability, (4) comprehensive general liability, (5) contractors' liability, (6) contractual liability exposure, (7) dentists' professional liability, (8) fiduciary liability, (9) hospital liability, (10) homeowners' liability, (11) lawyers' professional liability, (12) liquor liability, (13) physicians' and surgeons' professional liability, (14) pollution liability, (15) products' liability, and (16) store keepers' liability.

3. The Insurance Services Office, Commercial General Liability Policy (Claims Made Coverage, 1982, 1984), includes the following provision which is typical of the terms used in many liability insurance policies:

We will pay those sums that the insured becomes legally obligated to pay as damages because of "bodily injury" or "property damage" to which this insurance applies. . . . We will have the *right* and *duty* to defend any "suit" seeking those damages. . . .

(emphasis added).

4. One writer has observed that "insurance companies make every effort to keep the costs of defense as low as possible" and that defense firms, "well aware of this and, in order to retain these companies as clients, . . . keep defense costs down by refraining from, for example, filing unnecessary motions or taking unnecessary depositions." Browne, *The Demise of the Declaratory Judgment Action as a Device for Testing the Insurer's Duty to*

and to direct the defense to the third party's claim.⁵ Exercise of virtually complete control of the defense for an insured has been viewed as an appropriate approach because of the insurer's financial interest in the resolution of the claims.⁶

The practice of undertaking the defense when a claim is made or a suit is filed against an insured is undoubtedly widely known to the public. Consequently, purchasers have come to expect that liability insurers provide insureds with defenses to tort suits, as well as with indemnification (up to the limits of liability) for any judgment or settlement. Furthermore, the inclusion of provisions for the defense in liability insurance policies has generally meant that most consumers do not arrange separate coverage for defense expenses.

Provision for the defense of insureds as an integral feature of liability insurance arrangements undoubtedly affords some benefits for both insurers and insureds.⁷ Nevertheless, I believe that those advantages are now clearly outweighed by deleterious effects and unresolvable problems this approach frequently produces. The judicial response to some of these circumstances has been to sustain the right of an insured to abrogate the insurer's control over the defense thereby freeing the insured to select defense counsel, to direct the defense, and to have the defense expenses paid by the insurer.⁸ The thesis set forth here is that not only is this approach essential in some situations, but that in the future the roles and responsibilities of insurers providing indemnification for an insured's liability to third parties should *always* be separated from the function of providing defenses when suits are initiated against insureds.

Defend: A Postscript, 24 CLEV. ST. L. REV. 18, 25 (1975) [hereinafter Browne, *Postscript*]. Professor Browne also observed that an insured's independent counsel "is free to indulge in those marginally productive maneuvers and devices which would be prohibitive to counsel selected by the company." *Id.* What is thought by one attorney to be unnecessary may be viewed as essential by another, and "marginally productive" work has been known to win cases.

Also consider the comment by Thomas Cooney (a member of the Oregon Association of Defense Counsel, the American Board of Trial Advocates, the International Association of Insurance Counsel, and the Defense Research Institute): "Enormous pressures, either express or implied, can be exerted on defense counsel by an insurance company to forego or delay proper preparation." Cooney, *The Perils of Defense Counsel's Relinquishment of Control Over Preparation of the Defense to the Insurer*, 52 INS. COUNS. J. 259, 259 (1985).

5. Liability insurance is often characterized as a "third party" coverage because the insurance benefits usually are paid by the insurer directly to a third party, rather than to the insured who is the other party to the insurance contract.

6. For example, in *Parker v. Agricultural Ins. Co.*, 109 Misc. 2d 678, 681, 440 N.Y.S.2d 964, 967 (Sup. Ct. 1981), the court commented, "Giving the insurer exclusive control over litigation against the insured safeguards the orderly and proper disbursement of the large sums of money involved in the insurance business." *See also* *Kooyman v. Farm Bureau Mut. Ins. Co.*, 315 N.W.2d 30, 33 (Iowa 1982); *Aberle v. Karn*, 316 N.W.2d 779, 782 (N.D. 1982).

7. The advantages typically enumerated for the insurer include:

- (1) control over the opportunities for settlement of the claim against an insured,
- (2) opportunity to assure that the insured is represented by competent and skillful defense counsel,
- (3) control over the amount of expenses incurred for the defense,
- (4) control over the strategies and approaches employed in the defense of the insured, and
- (5) opportunity to apply the insurer's expertise to the settlement or defense of claims against insureds.

See infra discussion in Part B of the effect of introducing defense expenses insurance - that would cover the costs of independent defense counsel - on these interests of liability insurers who would still be providing coverage for sums which an insured is obligated to pay as damages.

8. *See infra* notes 54-55.

The first section of this article delineates some of the most serious and pervasive problems or issues encountered by insurers and insureds as a consequence of combining provisions for the defense of insureds with the obligation to indemnify. The second section initially analyzes the feasibility of disassociating the obligation to indemnify insureds from the right or duty to provide a defense and then briefly surveys three approaches that could be employed to implement such a separation. The third section considers some ways of addressing potential disadvantages which could result from severing the obligation to indemnify from the defense of insureds and concludes with a discussion of the advantages.

I. PROBLEMS ENCOUNTERED AS A RESULT OF COMBINING A LIABILITY INSURER'S OBLIGATION TO INDEMNIFY WITH THE PROVISION OF A DEFENSE FOR AN INSURED

During the first half century in which liability insurance was marketed in the United States, the coverage terms relating to the provision of a defense for insureds produced few issues of sufficient importance to the parties that the matters were considered by either the nation's appellate courts or the ethics committees of the country's bar associations. However, about fifty years ago several problems in this area began to be sufficiently significant that representatives of the insurance industry and the American Bar Association developed some guiding principles for insurance adjusters and defense counsel retained by insurers.⁹ For example, a 1939 statement of principles included the following declaration:

If any *diversity of interests* shall appear between the policy holder and the [insurance] company, the policyholder shall be fully advised of the situation and *invited to retain his own counsel*.¹⁰

Similarly, a statement of principles developed about twenty years later to address the relationship between lawyers and liability insurers included several different provisions which specified various circumstances in which an insurer was to "invite" the insured, at the insured's expense, to retain counsel. This is well illustrated by the "General Statement," set out as the first provision of these principles, which states:

If and when representation of the company by its attorney *conflicts with the interest* of the insured, the company and its attorney are under a duty to inform the insured of such conflict and *to invite him to retain his own counsel at his own expense*.¹¹

9. In 1940, the American Bar Association House of Delegates approved a policy which led to the preparation of "Statements of Principles" with respect to the practice of law in relation to various types of business and professional activities. Two decades later, the Conference of Lawyers and Casualty Insurers was constituted by a resolution of the American Bar Association House of Delegates.

10. *Statements of Principles with Respect to the Practice of Law Formulated by Representatives of American Bar Association and Various Lay Groups: Insurance Adjusters*, reprinted in 2 MARTINDALE-HUBBELL LAW DIRECTORY 85A-86A (83d ed. 1951) (emphasis added) (adopted January 8, 1939, by the Conference Committee on Adjusters, five of whom, including the Chairman, represented the American Bar Association) [hereinafter *Insurance Adjusters*].

11. *Statements of Principles with Respect to the Practice of Law Formulated by Representatives of American Bar Association and Various Lay Groups: Liability Insurers*, reprinted in 7 MARTINDALE-HUBBELL LAW DIRECTORY 76M-77M (110th ed. 1978) (emphasis added):

Inviting the "insured to retain his own counsel at his own expense" clearly did not (and does not) adequately serve or protect an insured when there is a diversity or a conflict of interests because it imposes the burden of legal expenses on insureds who do not anticipate such costs. Thus, it is not surprising that in the decades following the adoption of those principles, disputes about the rights and duties which relate to the defense of insureds have proliferated.

Among the problems encountered by insurers and insureds as a consequence of liability insurers undertaking the defense of claims against an insured, some of the most difficult and significant issues have arisen as a result of (1) conflicts of interests, (2) alleged failures of insurers to deal fairly and in good faith with the interests of the insureds in the course of providing defenses, (3) disputes about the existence or the extent of an insurer's obligation to provide a defense when the claim asserted by the third party may not be within the scope of the coverage defined by a liability insurance policy, and (4) controversies about an insurer's obligation to continue to provide a defense following the disbursement of coverage limits by paying a judgment, settling third party claims, or tendering the full amount of the applicable coverage to a court or to the insured.

A. *Conflict of Interests Problems*

Circumstances in which the interests of an insurer are in some way adverse to those of an insured can arise during almost every phase of the events that typically follow an injury to a third person that may be covered by liability insurance.¹² Nevertheless, in many situations when a tort suit is filed against an insured as a result of an activity that allegedly caused harms to the claimant, the insurer and insured reach an accord — either explicitly or implicitly — about an appropriate course of action to pursue in response to the tort claim.¹³ This is what occurs when — either before or after a law suit is filed — an insurer arranges a settlement in which the third party agrees to release the

The House of Delegates of the American Bar Association on February 7, 1972 approved 'Guiding Principles' previously adopted by the National Conference of Lawyers and Liability Insurers on May 22, 1969. Between that time and end of 1971, the 'Guiding Principles' were accepted by each of the major casualty and liability insurance companies in the United States. Action of the ABA House of Delegates followed on February 7, 1972.

Id.

This Statement of Principles, along with several others, was repealed in 1980 in the face of threats of anti-trust charges. See C. WOLFRAM, MODERN LEGAL ETHICS § 2.4.1 n.35 (1986). See also *Statements of Principles: Are They on Their Way Out?*, 66 A.B.A. J. 129 (1980).

12. Some conflicts may occur almost immediately after the occurrence of an insured event as a result of requirements established by the insurer for action an insured is to take following the occurrence of an event which is or may be within the scope of an insurance coverage. See sources cited *infra* note 17.

13. For example, in *American Mut. Liab. Ins. Co. v. Superior Court*, 38 Cal. App. 3d 579, 592, 113 Cal. Rptr. 561, 571 (1974), the court characterized the relationship among the "attorney, client-insured, and client insurer" as a "loose partnership, coalition or alliance directed toward a common goal, sharing a common purpose which lasts during the pendency of the claim or litigation against the insured." The court added: "Together, the team occupies one side of the litigation arena" in order to seek a favorable disposition of the claim against the insured. *But cf.* the comments in *Purdy v. Pacific Auto. Ins. Co.*, 157 Cal. App. 3d 59, 76, 203 Cal. Rptr. 524, 534 (1984): "As a practical matter, however, there has been recognition that, in reality, the insurer's attorneys may have closer ties with the insurer and a more compelling interest in protecting the insurer's position, whether or not it coincides with what is best for the insured."

insured from all liability claims in exchange either for some payment (usually by the insurer on behalf of the insured, but sometimes with a contribution by the insured) or for the dismissal of the insured's claim against the third party.

If a claim by a third party is not resolved through a settlement relatively soon after the matter arises, there is a very substantial possibility — almost a certainty when there is a very significant amount of damages at issue — that irreconcilable conflicting interests will confront an insurer and an insured,¹⁴ as well as defense counsel selected by the insurer.¹⁵ The circumstances or situations which may produce a conflict of interests for insurers, insureds, or defense counsel include:¹⁶

- (1) requirements established by the insurer for actions an insured is to take following the occurrence of an event which is or may be within the scope of the insurance coverage;¹⁷
- (2) requests by an insurer to an insured to accede to a notice of a reservation-of-rights or to accept a proposal for a non-waiver agreement;¹⁸
- (3) requests by an insured to a defense counsel selected by the insurer for advice about whether to accede to a notice from the insurer setting forth a reservation-of-rights or to accept a proposal for a non-waiver agreement;¹⁹
- (4) the roles, rights, and responsibilities of an insurer and the insured when insurance may not provide coverage for events giving rise to the tort claim — especially when the insured has objected to a reservation-of-rights notice or rejected a proposal for a non-waiver agreement;²⁰

14. See R. KEETON & A. WIDISS, *INSURANCE LAW* §§ 7.6(a), 7.6(b) (Practitioner's ed., 1988).

15. Conflict of interests problems are further complicated by the ethical responsibilities of the lawyers involved in representing the interests of the insurer or the insured. See R. KEETON & A. WIDISS, *supra* note 14, § 7.6(c).

See also 2 R. MALLIN & J. SMITH, *LEGAL MALPRACTICE* (3d ed. 1989); Holmes, *A Conflicts-of-Interest Roadmap for Insurance Defense Counsel: Walking an Ethical Tightrope Without a Net*, 26 WILLAMETTE L. REV. 1 (1989); Annotation, *Duty of Insurer to Pay for Independent Counsel When Conflict of Interest Exists Between Insured and Insurer*, 50 A.L.R.4th 932, 947-51 (1986) [hereinafter *Duty of Insurer*]; Annotation, *Malpractice: Liability of Attorney Representing Conflicting Interests*, 28 A.L.R.3d 389 (1969) [hereinafter *Malpractice*].

16. The following enumeration is adapted from a somewhat more comprehensive, but certainly not exhaustive, list in R. KEETON & A. WIDISS, *supra* note 14, § 7.6(a). See also the extensive analysis of conflicting interests in Holmes, *supra* note 15.

17. See the discussion of claims process requirements in R. KEETON & A. WIDISS, *supra* note 14, § 7.2. See also R. MALLIN & J. SMITH, *supra* note 15, § 23.19; Annotation, *Insured's Co-operation With Claimant in Establishing Valid Claim Against Insurer as Breach of Co-operation Clause*, 8 A.L.R.3d 1345 (1966); Annotation, *False Statements Favorable to Defense, Made and Persisted in By Insured, as Breach of Co-operation Clause*, 79 A.L.R.2d 1040 (1961); Annotation, *Automobile Liability Insurer's Waiver of Right, or Estoppel, to Set Up Breach of Co-operation Clause*, 70 A.L.R.2d 1197 (1960).

18. See the discussion of judicial precedents and the California legislative provision in *United States Fidelity and Guar. Co. v. Superior Court*, 204 Cal. App. 3d 1513, 1520-30, 252 Cal. Rptr. 320, 324-30 (1988). See also R. MALLIN & J. SMITH, *supra* note 15, § 23.16; A. WINDT, *INSURANCE CLAIMS AND DISPUTES* § 4.24 (1988); Holmes, *supra* note 15, at 40-47.

19. See the discussion of a defense counsel's obligation to inform the insured and the insurer of a conflict of interest in R. KEETON & A. WIDISS, *supra* note 14, § 7.6(c), at 831-32.

20. See, e.g., *Thornton v. Paul*, 74 Ill. 2d 132, 384 N.E.2d 335 (1978); *Gray v. Zurich Ins. Co.*, 65 Cal. 2d 263, 419 P.2d 168, 54 Cal. Rptr. 104 (1966); *Duty of Insurer*, *supra* note 15.

Also see the judicial decision included in R. MALLIN & J. SMITH, *supra* note 15, § 23.16; Note, *Conflict of Interest: Representing the Insured and Insurer When Liability Exceeds Coverage — An Ethical Enigma*, 9 MISS. C.L. REV. 341 (1989); Annotation, *Refusal of Liability Insurer to Defend Action Against Insured Involving Both*

(5) the roles, rights, and responsibilities of an insurer and the insured when the amount(s) claimed exceed the coverage limits of the applicable insurance;²¹

(6) the roles, rights, and responsibilities of an insurer and the insured when the insurer may be entitled to assert a defense to the insured's claim for coverage afforded by the insurer on the basis of a provision (such as a notice requirement) in the insurance policy — especially when the insured has objected to a reservation-of-rights notice or rejected a proposal for a non-waiver agreement;²²

(7) the roles, rights, and responsibilities of an insurer and the insured when the insurer is obligated to provide defenses for two or more insureds with adverse or antagonistic interests;²³

(8) decisions about the possible settlement of a claim asserted by a third party against an insured involving (a) when to propose a settlement, (b) how much to offer as a settlement, or (c) whether to accept a settlement offered by the third party asserting a claim against the insured (especially a proposal for an amount that is within the coverage limits);²⁴

(9) the use of information that is received by defense counsel in general and, in particular, whether information that is not known to one of the parties (e.g., the insurer or the insured) may be disclosed by the attorney to the insurer or the insured;²⁵

(10) choices about litigation strategies in the event the third party's claim is submitted to a court or arbitrator for adjudication;²⁶ and

(11) decisions about whether to seek appellate review following an adjudication of a third party's claim.²⁷

Claims Within Coverage of Policy and Claims Not Covered, 41 A.L.R.2d 434 (1955) [hereinafter *Refusal of Liability Insurer*].

21. When the damages sought by a third party claimant exceed the applicable coverage limits, there is a possibility that the insured will have personal liability that will not be indemnified by the insurer. Some courts have concluded that this exposure is sufficient to create a conflict of interests. *See, e.g.*, *Hartford Acc. & Indem. Co. v. Foster*, 528 So.2d 255 (Miss. 1988) (stating that attorneys, employed by the insurer to represent the insured in an action brought by an accident victim, had the responsibility to insure that the insured was notified he was being sued in excess of his liability insurance policy limits); *Bogard v. Employers Cas. Co.*, 164 Cal. App. 3d 602, 210 Cal. Rptr. 578 (1985). Other courts have concluded the conflict only occurs when there is an opportunity to reach a settlement within the coverage limits.

Also see the judicial decisions collected in *Duty of Insurer*, *supra* note 15, at 952-53; Gallagher, *The Problems of Defense Counsel Negotiating Settlement in Cases Involving a Potential Excess Judgment*, 37 INS. COUNS. J. 506 (1970).

22. See the discussion and authorities cited in R. MALLIN & J. SMITH, *supra* note 15, § 23.18; Holmes, *supra* note 15, at 32-38.

23. See the judicial decision included in R. MALLIN & J. SMITH, *supra* note 15, § 23.17; *Duty of Insurer*, *supra* note 15, at 941-44.

24. See the judicial decision included in R. MALLIN & J. SMITH, *supra* note 15, § 23.21; *Duty of Insurer*, *supra* note 15, at 953-54. See also the materials cited in the footnotes included in the subsection on disputes about whether the insurer acted in bad faith or dealt unfairly in conducting the defense of an insured, below.

25. See Holmes, *supra* note 15, at 61-74.

26. See A. WINDT, *supra* note 18, § 4.18 (particularly note 136); Holmes, *supra* note 15, at 87-96.

See also Annotation, *Liability Insurer's Duty to Defend Action Against an Insured After Insurer's Full Performance of Its Payment Obligations Under Policy*, 27 A.L.R.3d 1057 (1969) [hereinafter *Liability Insurer's Duty*].

27. See the discussion and judicial decisions cited in R. KEETON & A. WIDISS, *supra* note 14.

At least one of these circumstances is very likely to occur whenever a tort claim is asserted in a lawsuit against an insured. For example, reservation-of-rights notices and non-waiver agreements are frequently employed by liability insurers. When an insured accedes to such a proposal, there is clearly a diversity of interests. This was recognized in one of the *Statement of Principles* adopted by the American Bar Association in 1939, which provided:

If any *diversity of interest* shall appear between the policy-holder and the company, the policyholder shall be fully advised of the situation and invited to retain his own counsel. Without limiting the general application of the foregoing, it is contemplated that *this will be done . . . in any case in which the company is defending under a reservation of rights, . . .*²⁸

Another type of situation that frequently produces a diversity or conflict of interests — which underscores how pervasive they are — exists when claims by third parties exceed the applicable coverage limits of an insured's liability insurance.²⁹ In such instances, the insurer's decision to reject an opportunity to settle the claim *may* present a divergence of interests even though it is not for an amount that is within the coverage limits.³⁰ And, it almost always produces an irreconcilable conflict when an insurer rejects a settlement opportunity for an amount that is within the coverage provided by an applicable liability insurance policy.³¹

The potential for and significance of conflicting interests is often a matter of considerable importance to the parties.³² Furthermore, during the past decade, the increasingly widespread recognition of the existence and significance of conflict of interest problems³³ has transformed these questions into matters that must be addressed by insurers and defense attorneys,³⁴ as well as by the courts.

When the obligation to indemnify is coupled with the defense of the insured, the insurance company may be inclined to minimize the defense expenses. An insurer may even be tempted "to make every effort to keep the costs of defense as low as possible." Browne, *Postscript*, *supra* note 4, at 25.

28. *Insurance Adjusters*, *supra* note 10 (emphasis added).

29. If any diversity of interest shall appear between the policyholder and the company, the policyholder shall be fully advised of the situation and invited to retain his own counsel. Without limiting the general application of the foregoing, it is contemplated that *this will be done in any case in which it appears probable that an amount in excess of the limit of the policy is involved, . . .*

Id. (emphasis added).

However, in California "no conflict of interest shall be deemed to exist . . . solely because an insured is sued for an amount in excess of the insurance policy limits." CAL. CIV. CODE § 2860(b) (West 1990).

30. See A. WINDT, *supra* note 18, § 5.06. See also materials cited *infra* note 61.

31. See materials cited *infra* note 61.

32. In some of these circumstances, the role and responsibility of a lawyer selected by the insurer as defense counsel is not only a matter of central importance to the parties, but is also the focal point of the questions that relate to the conflict of interests. See R. KEETON & A. WIDISS, *supra* note 14, § 7.6(c). See also A. WINDT, *supra* note 18, §§ 4.18-21; Holmes, *supra* note 15; *Malpractice*, *supra* note 15.

33. In assessing the import of conflicting interests on malpractice liability, Mallen and Smith observed: Not only has the complexity of modern litigation increased, but so have the obligations of the insurer to its insured. *The latter development has increased the potential for a conflict of interests between the insured and insurer and has impaired the ability of insurance counsel to competently represent the interests of multiple clients.*

R. MALLEN & J. SMITH, *supra* note 15, at 360 (emphasis added).

34. Both the insurer and the attorney selected by the insurer to undertake the defense of an insured have fiduciary obligations to inform of a conflict of interests and its consequences, so that the insured is afforded an opportunity to have independent advice and counsel. See, e.g., *Manzanita Park v. Insurance Co. of North*

Insurers, sometimes in association with a defense counsel selected by the insurer, have responded to potential or actual conflict of interest problems in a variety of ways, including:

- (a) denial of coverage and refusal to provide a defense;
- (b) withdrawal from the representation of the insured by the initial attorney designated by the insurance company;
- (c) elimination of the conflict through a "waiver" by the insurer of a coverage limitation or defense;
- (d) declaratory judgment proceedings;
- (e) disclosure of the conflict and consent by the insured to preserve the insurer's right to an adjudication of a coverage question;
- (f) continuation of the representation by the defense counsel after disclosure even though nothing is done to address the conflict; and
- (g) intervention by the insurer as party in the third party action against the insured or by a motion to consolidate a declaratory judgment proceeding with the third party's suit against the insured.

Unfortunately, each of these approaches either involves significant disadvantages for one or both of the parties (that is, the insurer and the insured) or fails to eliminate the conflicting interests.

1. *Denial of Coverage and Refusal to Provide a Defense*

In some instances, liability insurers deny or disclaim coverage and also refuse to provide any defense for an insured. If the insurer's decision about the applicability of the liability coverage proves to have been incorrect, this approach has several disadvantages for the insurer. *First*, having declined a role in the defense, the insurer forfeits any advantages — perceived or actual — which are to be derived from combining the obligation to indemnify with the right to provide an insured's defense to a claim that may be covered by a liability insurance policy. For example, the insurer cannot monitor whether the defense of the insured is being pursued effectively and vigorously. *Second*, in the event a court subsequently decides that the insurer should have defended the insured, the insurer may be foreclosed from litigating issues that were adjudicated in the resolution of the third party's claim against the insured or, at least in some instances, that were implicitly resolved by a settlement of the third party's claim.³⁵ *Third*, if the insurer's actions — that is, the decision to disclaim liability and to refuse to provide a defense — are subsequently determined to have

America, 857 F.2d 549, 555 (9th Cir. 1988) (applying Arizona law based on *Fulton v. Woodford*, 26 Ariz. App. 17, 20, 545 P.2d 979, 982 (1976)).

The American Bar Association Code of Professional Responsibilities, EC 5-17 specifically states that insurance defense work involves recurring situations that involve potentially differing interests.

See also Williams & Jernberg, *Conflicts of Interest in Insurance Defense Litigation: Common Sense in Changing Times*, 31 FED'N OF INS. COUNS. Q. 111 (1981).

35. Even though an insurer has not participated in the action by the third party against the insured because of a conflict of interests in relation to some issue other than those adjudicated in that action, especially when a matter was fully adjudicated on the merits the insurer may be foreclosed from relitigating the matter. See generally, R. KEETON & A. WIDISS, *supra* note 14, § 7.6(e), at 860-64; A. WINDT, *supra* note 18, § 4.35.

not been justified, the insurer's breach of its obligations to the insured will expose the insurer to liability for consequential damages that the insured may sustain (the costs of both the defense to the third party claim *and* the successful suit against the insurer for a breach of contract in not providing a defense).³⁶ *Fourth*, there is also a possibility that the insurer's actions will justify a claim for punitive damages on the basis that the insurer breached the obligation to deal fairly and in good faith.³⁷

There is, of course, also a possibility that the insurer correctly disclaimed liability and the obligation to provide a defense. For most insureds, the approach of incorporating provisions for the defense into various types of liability insurance policies has, in effect, discouraged them from even examining the possibility of acquiring separate coverage for legal expenses.³⁸ Thus, when an insurer appropriately rejects the insured's request for a defense, the insured is left without any coverage for defense expenses.

2. *Withdrawal by the Attorney Whom the Insurance Company Designated to Provide the Defense for an Insured*

When defense counsel selected by an insurer to represent an insured confronts a significant conflict of interests, the attorney may decide that it is appropriate to withdraw from the representation or the insurer may ask the attorney to withdraw.³⁹ If the lawyer is permitted to withdraw, this approach involves both delays and expenses incident to the retention of a new attorney who almost always has to replicate at least some of the case preparation done by the defense counsel originally selected by the insurer. Obviously, this increases the

36. See R. KEETON & A. WIDISS, *supra* note 14, § 9.5(b), at 860-64. Allan Windt observed:

Turning to the issue of consequential damages, an insured should, whenever suing an insurer for breach of its duty to defend, consider seeking compensation for such things as:

1. Interest on loans necessitated by the insured's having to bear his or her own defense costs
2. Additional costs incurred because of an inability to obtain cash discounts from suppliers
3. Damage to credit rating resulting from a cash flow problem
4. Loss of prospective business due to a lowering of the insured's bonding capacity
5. Loss of interest on funds needed to pay for the defense
6. Damage to the insured's business reputation
7. Mental distress

A. WINDT, *supra* note 18, § 4.32.

Windt also suggests that there are a number of practical disadvantages that result from an insurer's breach of the duty to defend, including:

First, it will empower insureds to settle the claims made against them without obtaining the insurer's approval. Assuming the amount of the settlement is reasonable and the insurer otherwise provides coverage, the insured can require the insurer to reimburse him or her, regardless of the company's resistance to the settlement. . . . Fifth, it will deprive the insurer of its right to insist that the insured cooperate with it and thereby deprive the insurer of the ability easily to obtain information from the insured that might be used to defeat the insured's coverage claim. And sixth, it will allow the insured to enter into an unauthorized settlement with and release of any person that may have been liable to the insured, thereby destroying the insurer's subrogation right. [Footnote omitted.]

Id. at § 4.36.

37. See *id.* for the analysis of practical disadvantages.

38. And if the insured litigates this question, the insured not only incurs the expenses of defending against the claim by the third party, but also the costs involved in subsequently—albeit unsuccessfully—suing the insurer.

39. See R. KEETON & A. WIDISS, *supra* note 14, § 7.6(c)(4). See also Holmes, *supra* note 15, at 71-75.

defense expenses. Moreover, following a withdrawal there are other problems which cannot simply be redressed as financial matters.

In most instances any single attorney subsequently selected by the insurer as a replacement will confront the same conflict.⁴⁰ Consequently, withdrawal of the defense counsel selected by the insurer is, at best, usually a palliative which eliminates the problem for that attorney without ameliorating the underlying problem — that is, the withdrawal does not address or eliminate the circumstances that produced the conflict. Furthermore, it is often impossible for an attorney to withdraw without prejudicing the interests of the insured, the insurer, or — in some instances — both parties.⁴¹ For example, withdrawal — or even the attempt to withdraw — from the representation for ethical reasons may effectively raise suspicions about the reasons for the attorney's action on the part of the insurer, a judge, or a jury if it occurs in the course of trial.

3. "Waiver" by the Insurer of a Coverage Limitation or Defense

Following the disclosure of a conflict of interests, an insurer may decide that its interests would be best served by relinquishing the right to subsequently assert any defenses that are based on or relate to the matter that produced the conflict.⁴² An insurer that wants to direct the insured's defense can agree to address the problem by waiving any rights it may have in regard to the matter that produces the conflict.

A waiver is generally disadvantageous to the insurer — that is, the company gives up the right to assert a defense. Therefore, typically this approach will only be employed when the insurer concludes either (a) that its interests in minimizing its liability will best be served by providing the defense⁴³ or (b) that the good will of the insured is sufficiently important to justify the insurance company's abandonment of a coverage defense. These conditions exist in relatively few instances. Therefore, while this is an effective way to address a conflict, it is only rarely used by insurers in practice because most insurers do not conclude that the company's interest is served by abandoning coverage defenses.

40. See Holmes, *supra* note 15, at 71-75. See also Rotunda, *The Notice of Withdrawal and the New Model Rules of Professional Conduct: Blowing the Whistle and Waving the Red Flag*, 63 OR. L. REV. 455, 471-81 (1984).

41. Consider the comments of Professor Holmes:

But the insured *may* in fact lose something because counsel must give some explanation for his withdrawal, if only some cryptic reference to a conflict of interests or ethical problem. . . . Even if the attorney does not state the reason for withdrawal, mere notice to both clients can signal a serious coverage issue.

Holmes, *supra* note 15, at 73.

42. In *Maryland Casualty Co. v. Peppers*, 64 Ill. 2d 187, 198, 355 N.E.2d 24, 31 (1976), the court observed that if the insurer "waives its defense of noncoverage by the policy of an intentional injury and defends without asserting a reservation of rights or a nonwaiver agreement as to such an injury the conflict of interests will be removed." When an insurer decides to pursue this course, there should be a clear and unequivocal written understanding with the insured about the matter(s) that relate to the conflicting interests.

43. Sometimes insurers are concerned that an insured may retain less competent defense counsel than would be selected by the insurer. Consider the comments of Browne, *Postscript*, *supra* note 4, at 25.

4. Declaratory Judgment Proceeding

Insurers have often sought to address a conflict of interests — especially one that involves the assertion that no coverage exists so that there would be no duty to provide a defense — by initiating a declaratory judgment action.⁴⁴ There are several disadvantages or problems with attempting to resolve conflicts in this way.

First, this approach involves additional legal expenses. In those instances when the insurer loses, it will still be obligated to provide the defense. In addition, it may even be liable for the insured's legal expenses incurred for the declaratory judgment action.⁴⁵ Furthermore, if the insurer prevails in the declaratory judgment action, it will invariably be at the cost of the insured's good will⁴⁶ which almost certainly will have been forfeited in the course of the declaratory judgment action and, if not then, when the insured has to subsequently pay the bills incurred in the defense to the third party claim. And, unfortunately, the expenses incurred are only the most obvious disadvantage.

In many circumstances, the primary difficulty presented by attempting to secure a declaratory judgment is the time entailed in reaching an adjudication of the matter. The amount of time it takes to resolve the coverage question is particularly troublesome when one or more of the issues involve factual questions that may have to be tried before a jury.⁴⁷ Consequently, often decisions will have to be made about whether the insurer should participate in settlement negotiations or the defense of the tort suit against the insured long before a declaratory judgment proceeding can be concluded. Furthermore, there are situations in which courts have decided that the declaratory action must await the resolution of issues in the third party claim against the insured⁴⁸ so that a declaratory judgment proceeding actually offers only the illusion of a solution to conflict of interest problems.⁴⁹

44. See generally, Ericsson, *Declaratory Judgment: Is It a Real or Illusory Solution?*, 23 TORT & INS. L.J. 161 (1987); Note, *Use of Declaratory Judgment to Determine a Liability Insurer's Duty to Defend — Conflict of Interests*, 41 IND. L.J. 87 (1965).

45. See Ericsson, *supra* note 44, at 170-78.

46. Consider the comment from Treece & Hall, *When Do You File a Declaratory Judgment Action?*:

Starting a declaratory judgment action forces the insured to incur considerable legal expense by forcing him to engage independent personal counsel to litigate such action. Whatever goodwill the insured still has toward the insurance company despite the disagreements over coverage will be dissipated by the filing of such an action against him.

Treece & Hall, *When Do You File a Declaratory Judgment Action?* 53 INS. COUNS. J. 396, 399-400 (1986).

47. E.g., *Northland Ins. Co. v. Heck's Service Co.*, 620 F. Supp. 107, 108 (E.D. Ark. 1985) ("that resolution of the issue of whether coverage for any property damage exists must await the outcome of Eckler's [the third party] suit against Heck's."). See also Ericsson, *supra* note 44, at 167-69.

48. *Northland Ins. Co.*, 620 F. Supp. at 108. Cf. *Murphy v. Urso*, 88 Ill. 2d 444, 455, 430 N.E.2d 1079, 1084 (1982) ("declaratory judgment would be only a forerunner of the accident trial, and would resolve nothing" when the coverage questions are substantially the same as those at issue in the third party's suit against the insured.) See also *Maryland Casualty Co. v. Peppers*, 64 Ill. 2d 187, 197, 355 N.E.2d 24, 30 (1976).

49. See also Holmes, *supra* note 15, at 50-53, in which Professor Holmes enumerates a number of other procedural and substantive drawbacks for the insurer, including:

First, courts uniformly hold that the power to grant declaratory relief is discretionary.

...

A third drawback relates to the burden of proof. The insurer as plaintiff in the declaratory action would have the burden of proving no coverage or a contract defense to coverage.

Finally, if the insurer prevails in the declaratory judgment action, there is no coverage for defense expenses because most insureds have been lulled into what sometimes turns out to be a false sense of security in regard to commitments by liability insurers to undertake the defense of insureds.

*5. Acquiescence of the Insured to be Represented by a Defense Counsel Selected by the Insurer With an Agreement That the Insurer Has Not Lost the Right to a Subsequent Adjudication of the Coverage Question*⁵⁰

Insurance companies frequently seek to provide an insured's defense — including the selection and direction of defense counsel — while preserving the right to raise coverage defenses by either sending an insured a reservation-of-rights notice or by proposing that the insured accept a non-waiver agreement.⁵¹ The most apparent problem associated with this approach is that acquiescence to such a notice or acceptance of such an agreement does not eliminate the conflict.⁵² Whenever there is a possibility that a coverage defense may be asserted by a liability insurer, until and unless that matter is resolved an actual or a potential conflict of interests exists for the insurer and the insured because the insurer's actions in the "handling" of matters related to the claim(s) against the insured may be influenced by the expectation that the coverage defense will be successful.⁵³

Insureds do not invariably acquiesce to an insurer's request for a non-waiver agreement or the declaration set forth in a reservation-of-rights notice. Increasingly during the last decade, insureds have gone to court with suits urging that it is unreasonable for an insurer to have the advantage of controlling

A fourth drawback relates to finances. The declaratory action is expensive, especially if the insurer is unsuccessful. . . .

As a fifth drawback, the third-party claimant may discover facts from the declaratory proceeding that are adverse to the insured's interests. . . .

Finally, there are certain psychological drawbacks. . . . An insured may become a hostile adversary against the insurer as a result of the filing. Also, an insurer's initiating litigation against a client could adversely affect the goodwill of its business.

Id. at 50-53.

See also, Treece & Hall, *supra* note 46; Browne, *The Demise of the Declaratory Judgment Action as a Device for Testing the Insurer's Duty to Defend*, 23 CLEV. ST. L. REV. 423 (1974) and Browne, *Postscript*, *supra* note 4.

50. In many circumstances there may be a question about whether the claims against an insured result from an activity or an occurrence that is within the scope of the applicable liability insurance policy or whether the insured has done something which eliminates coverage. Liability insurance policies uniformly include limitations or restrictions on (1) the persons who are insured, (2) the interests of the insured that are protected, (3) the scope of the risks which are transferred to the insurer, and (4) conditions with which the insured must comply. See R. KEETON & A. WIDISS, *supra* note 14, § 7.6(a); Holmes, *supra* note 15, at 14-38.

51. See R. KEETON & A. WIDISS, *supra* note 14, at § 6.7(a)-7.6(d)(3); Holmes, *supra* note 15, at 40-46.

52. An insured who does not have the resources to pay an attorney may feel compelled to accept the defense proffered by the insurer subject to a reservation of rights notice or non-waiver agreement.

53. For example, the Washington Supreme Court observed that "the same standard of fair dealing and equal consideration is unquestionably applicable to a reservation-of-rights defense" and "that the potential conflicts of interest between insurer and insured inherent in this type of defense mandate an even higher standard: an insurance company must fulfill an enhanced obligation to its insured as part of its duty of good faith." *Tank v. State Farm Fire & Casualty Co.*, 105 Wash. 2d 381, 387, 715 P.2d 1133, 1137 (1986). See also *Thorton v. Paul*, 74 Ill. 2d 132, 384 N.E.2d 335 (1978) (in which the court also commented that a defense under a reservation of rights does not solve the ethical question posed by a conflict of interests).

the litigation (through an attorney selected, instructed, and paid by the insurance company) and to also retain the right to thereafter contest liability.⁵⁴ In response to such claims by insureds, courts in many states have now held that when⁵⁵ there is a conflict of interests, insureds are entitled to select an independent defense attorney, to direct the defense, and to have the reasonable defense expenses paid by the insurer. And the California legislature has now codified the insured's right to select independent counsel.⁵⁶

Judicial decisions terminating or suspending an insurer's right to select defense counsel or to direct the defense sever the obligation to indemnify from the obligation to provide a defense for the insured against a third party claim. All that remains for the liability insurer is an undelimited financial obligation to pay all or some portion of the defense costs. When this occurs, the insurer incurs burdens without benefits.

6. *Continuation of the Representation by the Defense Counsel After Disclosure Even Though Nothing is Done to Address The Conflict*

Insurers have sometimes continued to provide the defense for an insured with knowledge of a conflict of interest. Obviously, this does nothing to address the conflict. Thus, it is not surprising that one of the principal disadvantages of this approach for the insurer is that the insurer may be precluded from asserting any coverage defense that relates to the matter which created the conflict.⁵⁷ In the future, few insurers are likely to adopt this practice because it affords virtually no significant advantages for the insurer (or for the insured in those states which sustain the right of the insured to select defense counsel who will be paid by the insurer).

54. See the judicial decisions collected in R. MALLIN & J. SMITH, *supra* note 15, at 405-07; *Duty of Insurer*, *supra* note 15, at 932-59. See also the judicial decisions cited in Note, *The Insured's Right to Choose Defense Counsel*, 24 TULSA L.J. 281, 288-89 (1988).

55. See references *supra* note 54. The judicial decisions collected in the Annotation, *Duty of Insurer*, *supra* note 15, are organized under the following categories:

- § 3. Multiple insureds with antagonistic interests,
- § 4. Reservation of rights,
- § 5. Allegations within and outside coverage,
- § 6. Damages sought in excess of policy limits,
- § 7. Misconduct of insurer in conducting defense
 - [a] General misconduct,
 - [b] Failure to settle,
 - [c] Settlement without consent of insured.

Id. at 941-55.

56. If the provisions of a policy of insurance impose a duty to defend upon an insurer and a conflict of interest arises which creates a duty on the part of the insurer to provide independent counsel to the insured, the insurer shall provide independent counsel to represent the insured unless, at the time the insured is informed that a possible conflict may arise or does exist, the insured expressly waives, in writing, the right to independent counsel. An insurance contract may contain a provision which sets forth the method of selecting that counsel consistent with this section.

CAL. CIV. CODE § 2860(a) (West Supp. 1990).

57. See, e.g., *Schmidt v. National Auto. & Casualty Ins. Co.*, 207 F.2d 301 (8th Cir. 1953). See also Annotation, *Liability Insurance: Insurer's Assumption of or Continuation in Defense of Action Brought Against the Assured as Waiver or Estoppel as Regards Defense of Noncoverage or Other Defense Existing at Time of Accident*, 38 A.L.R.2d 1148 (1954); Note, *supra* note 44, at 92-93.

7. *Inclusion of the Insurer as Party in the Third Party's Suit.*

In some circumstances, a liability insurer may seek to be included as a party in the suit by the third party against the insured by either (a) intervening as party in the third party's action or (b) moving to consolidate a declaratory judgment action with the third party's suit. Undoubtedly, there are conflict of interest situations in which intervention or consolidation can appropriately be urged on the rationale that every individual or entity whose interests would be affected by that adjudication should be a party to such an action.⁵⁸ One disadvantage of this approach is that the presence of the insurance company as a party in the underlying litigation initiated by the third party against the insured usually is a complicating factor, especially if there is a desire to mask the identity of the insurer from a jury.⁵⁹ However, even more fundamentally, this approach does not eliminate the conflict of interests. In effect, it places the insurer in opposition to the insured it is obligated to defend (pursuant to the liability insurance coverage) because the insurer is defending itself against liability under that coverage. If an insurer seeks such a consolidation, equity demands that the insurance company relinquish the right to control the insured's defense to the third party's claim.

To recapitulate: The approaches employed by insurers to respond to conflicting interests often have significant disadvantages for insurers, and generally do not well serve either the needs or the concerns of the insureds either. In particular, they often involve additional costs and frequently are fundamentally at odds with the insured's expectation that insurance has been arranged which will provide a defense in the event the insured is sued. Moreover, several of the approaches do not eliminate the conflict for the parties.

B. *Disputes About Whether the Insurer Acted in Bad Faith or Dealt Unfairly in Conducting the Defense of an Insured*

In recent years, when a claim against an insured has resulted in a judgment in excess of the applicable liability coverage, insureds have frequently filed suits which have required courts to assess a liability insurer's conduct of the defense in relation to the obligation to deal fairly and in good faith with the interests of the insured. Many, and perhaps most, of the bad faith claims against liability insurers stem directly or indirectly from having combined insurance arrangements for indemnification of insureds with the insurer's right to control the defense of insureds. Often, but not always, the focus of these suits is on the insurer's decision not to accept an offer to settle the third party's claim.⁶⁰

It is now evident that an insurer can no longer exercise unrestricted discretion in regard to deciding whether to take advantage of settlement opportunities

58. See 20 J. APPLEMAN, *INSURANCE LAW AND PRACTICE* §§ 11331-35 (1980).

59. However, when the inclusion of the insurer as a party in the third party's suit is at the instance of the insurance company, the concerns that normally justify withholding such information from the jury are certainly lessened.

60. See generally, 7C J. APPLEMAN, *INSURANCE LAW & PRACTICE* (Berdal ed., 1979); A. WINDT, *supra* note 18, ch. 5.

and in regard to the selection of defense strategies.⁶¹ Furthermore, it is equally apparent that recognition that there are some limitations on insurers has not led to the enunciation of standards which provide clear guidance for the individuals who are responsible for decisions about whether to accept settlement proposals or defense strategies. Moreover, year by year, the volume of litigation in which insureds have asserted claims for consequential and punitive damages because an insurer elected to pursue the company's interests over the insureds' has continued to increase.⁶²

The circumstances which produce bad faith claims frequently entail and could be conceptualized as conflict of interests problems.⁶³ However, much of the litigation has neither been grounded on conflicting interests nor analyzed in those terms. Therefore, when surveying the costs to insurers and insureds — including loss of good will, litigation expenses, and substantial damage awards against insurers — which are a product of incorporating the defense arrangements into liability insurance policies, a significant portion of the litigation asserting bad faith claims against liability insurers certainly warrants consideration as a separate group of problems.

C. *Disputes About the Existence and Extent of the Insurer's Obligation to Provide a Defense*

Insurers sometimes decline an insured's request to undertake the defense on the ground that the third party's claim does not result from an occurrence to which the insurance applies. In many instances, refusals by insurers have produced disputes about the scope or extent of a liability insurer's obligation to provide a defense.⁶⁴ In these cases, appellate courts have repeatedly held that the scope of the insurer's defense obligation is more extensive or "broader" than the obligation to indemnify the insured.⁶⁵ This means that a liability insurance company is sometimes required to provide a defense even though the insurer may not be obligated to provide indemnification for the insured's liability to a third party. Although this interpretation of the coverage terms has frequently been affirmed by appellate courts throughout the nation, those decisions have

61. See generally J. APPLEMAN, *supra* note 60; R. KEETON & A. WIDISS, *supra* note 14, § 7.8; 1A R. LONG, *THE LAW OF LIABILITY INSURANCE* (1986); A. WINDT, *supra* note 18, ch. 5 & § 4.18.

62. See cases cited in materials *supra* note 61.

63. For example, when a third party's suit against an insured results in a judgment that is in excess of the insured's liability insurance coverage, whether the insurer preferred *its interests over those of its insured* in assessing settlement possibilities or in selecting litigation strategies is often at the heart of disputes between the insured and insurer.

64. See R. KEETON & A. WIDISS, *supra* note 60, § 9.3; J. APPLEMAN, *supra* note 60, §§ 4682-86; G. COUCH, *CYCLOPEDIA OF INSURANCE LAW* § 51:148-177 (2d ed., 1982); *Refusal of Liability Insurer*, *supra* note 20.

65. For example, in *Pennsylvania Mfrs. Ass'n Ins. Co. v. Lumbermens Mut. Casualty Co.*, 648 F.2d 914, 918 (3d Cir. 1981), the court observed that the inclusion of the defense clause "has the effect of imposing separate and distinct obligations on a liability insurance carrier to pay damages against its insured and to provide a defense" and that "[t]he two duties are not coterminous and a carrier may be obligated to defend its insured in circumstances where the damage award itself may be payable by another insurance company, other party, or the insured himself."

not inhibited a continuing flow of disputes about its application in specific contexts.⁶⁶

The proposition is frequently stated that an insurer's obligation to defend an insured is determined by the nature of the claim set forth in the allegations of the suit against the insured.⁶⁷ This statement is a generalization which is subject to several qualifications and, consequently, has produced significant amounts of litigation between insurers and insureds.⁶⁸ Questions about whether the allegations in a tort complaint are decisive in regard to the duty of a liability insurer to provide a defense — that is, whether this duty is to be determined exclusively on the basis of the allegations in a lawsuit against an insured — have arisen in many different types of circumstances,⁶⁹ including:

- (1) pleadings that include some allegations of tortious conduct that is not within the scope of the insurance coverage and some allegations of tortious conduct that is within the coverage;
- (2) pleadings that do not allege any claim that is within the scope of the insurance coverage;
- (3) pleadings with allegations that are ambiguous in regard to the type of tortious conduct, and
- (4) pleadings that set forth allegations which are groundless, false, or fraudulent.

Judicial precedents in many states make it clear that decisions about whether a liability insurer is obligated to provide a defense for an insured should not be predicated exclusively on an examination of the third party claimant's pleadings.⁷⁰ Consequently, whether a liability insurer is obligated to defend frequently depends on many factors and this uncertainty fosters litigation between insurers and insureds.

The objective of the discussion here is not to examine the merits of how disputes about the scope of the defense obligation are to be resolved. Rather the point is that the inclusion of the provisions for the defense of insureds with the obligation to indemnify produces many circumstances in which there are disputes between insurers and insureds about the existence and extent of the obligation to defend that frequently cannot be easily resolved by the parties.

66. For example, see the judicial decisions compiled in A. WINDT, *supra* note 18, ch. 4; R. LONG, *supra* note 61, § 5.01. See also J. APPLEMAN, *supra* note 60, ch. 7A, §§ 4682-83.

67. *Seaboard Sur. Co. v. Gillette Co.*, 64 N.Y.2d 304, 310, 476 N.E.2d 272, 275, 486 N.Y.S.2d 873, 876 (1984); *Continental Casualty Co. v. Gilbane Bldg. Co.*, 391 Mass. 143, 146, 461 N.E.2d 209, 212 (1984); *Union Mut. Fire Ins. Co. v. Inhabitants of the Town of Topsham*, 441 A.2d 1012 (Me. 1982).

Also see the judicial decision included in J. APPLEMAN, *supra* note 60, ch. 7C, § 4683; R. LONG, *supra* note 61, § 5.02; A. WINDT, *supra* note 18, §§ 4.03-.06; Annotation, *Allegations in Third Person's Action Against Insured as Determining Liability Insurer's Duty to Defend*, 50 A.L.R.2d 458 (1956).

68. See R. KEETON & A. WIDISS, *supra* note 14, § 9.3(a).

69. *Id.* at 1009-10. See also R. JERRY, *UNDERSTANDING INSURANCE LAW* § 111 (1987).

70. An extensive analysis of the foregoing four classes of cases may be found in R. KEETON & A. WIDISS, *supra* note 14, § 9.3(b), at 1007-25.

Also see the judicial decision included in J. APPLEMAN, *supra* note 60, §§ 4682-86; R. LONG, *supra* note 61, §§ 5.02-.06; A. WINDT, *supra* note 18, §§ 4.03-.06; Annotation, *Consequences of Liability Insurer's Refusal to Assume Defense of Action Against Insured Upon Ground That Claim Upon Which Action is Based is not Within Coverage of Policy*, 49 A.L.R.2d 694 (1956); *Refusal of Liability Insurer*, *supra* note 20.

D. *Disputes About Termination of the Obligation to Defend When Insurance Benefits Have Been Disbursed*

Insurers have generally viewed the defense obligation as a function of the obligation to indemnify so that when the applicable coverage is exhausted, the insurer is no longer required to provide a defense.⁷¹ In some cases, even though the full amount of the coverage was used in settling a portion of the claims or by paying one or more judgments against the insured, the insured has argued that the insurer's obligation to provide a defense continued.⁷² The judicial precedents on this question are divided.

Judicial decisions in several states have held that an insurer's duty is discharged after the available coverage has been used for the payment of a judgment.⁷³ However, in these states, judges have sometimes distinguished instances in which the insurer has disbursed the coverage for settlements or by tendering the available coverage to a court from circumstances in which the coverage has been exhausted by the payment of a judgment against the insured.⁷⁴

Courts in other states have decided the duty to provide a defense is not discharged even though the insurer has disbursed an amount equal to the liability insurance coverage limits as a result of a judgment.⁷⁵ This result has usually been predicated on the view (1) that an insurer's duty to defend an insured and the duty to indemnify are separate and distinct, so that the duty to defend is not dependent on the duty to indemnify; (2) that the duty to defend is "broader" than the duty to indemnify; and/or (3) that it is inappropriate for an insurer to abandon the insured in the midst of a pending litigation of the claims. Whatever the rationale for these decisions, such disputes are a product of combining the obligation to indemnify insureds for liability with the arrangement for the defense of the insureds.

The disputes in these cases constitute another group of controversies that result from the integration of the defense arrangement into liability insurance coverages. Furthermore, if the insurer is obligated to provide the insured's defense after the coverage limits have been exhausted, it creates a serious conflict of interests for a liability insurer that no longer has a financial interest in the outcome of the claims against the insured and, therefore, has little incentive to spend money on the insured's defense. Alternatively, if the insurer is not obli-

71. For example, see the judicial decisions cited in R. KEETON & A. WIDISS, *supra* note 14, § 9.4(c)(3).

Also see G. COUCH, *supra* note 64, §§ 51-53, at 1032-43; R. LONG, *supra* note 61, § 5.25; A. WINDT, *supra* note 18, § 4.30.

72. See cases cited *supra* note 71. Also see judicial decisions cited in R. KEETON & A. WIDISS, *supra* note 14; Annotation, *Liability Insurer's Duty to Defend Action Against an Insured After Insurer's Full Performance of its Payment Obligation Under Policy*, 27 A.L.R.3d 1057 (1969).

73. See cases cited *supra* notes 71-72. See, e.g., materials cited in R. KEETON & A. WIDISS, *supra* note 14, § 9.4(c)(3) n.18.

74. See, e.g., *Samplly v. Integrity Ins. Co.*, 476 So. 2d 79, 83-84 (Ala. 1985) (holding that a liability insurer "cannot avoid its duty to defend against an insured's contingent liability by tendering the amount of its policy limits into court without effectuating a settlement or obtaining the consent of the insured"). It should be noted that in some instances, the transfer of the defense may have involved significant problems.

75. See, e.g., *Conway v. Country Casualty Ins. Co.*, 92 Ill. 2d 388, 442 N.E.2d 245 (1982); *Palmer v. Pacific Indem. Co.*, 74 Mich. App. 259, 264-65, 254 N.W.2d 52, 55 (1977).

gated, the insured is usually left without any insurance arrangements for defense expenses.

The foregoing delineation of problems is by no means an exhaustive compilation of either the ethical dilemmas or legal disputes about the nature and scope of the defense obligation. However, the problems enumerated well illustrate the difficulties which insurers and insureds frequently have to address. From the occurrence of an insured event to the adjudication of the third party claim — and sometimes even beyond that point⁷⁶ — the relationships between liability insurers and insureds are plagued by such issues. And whenever a suit is filed against an insured, at least one of these problems is very likely to be encountered.

If liability insurers were not committed to providing defenses for insureds, virtually all of the issues considered in the preceding subsections would not arise. Accordingly, I believe that this complex of problems provides ample justification for examining the feasibility, advantages, and disadvantages of separating insurance arrangements that provide coverage for defense expenses from liability insurance policies.

II. FEASIBILITY OF AND APPROACHES TO IMPLEMENTING A SEVERANCE OF INDEMNIFICATION COVERAGE AND INSURANCE FOR DEFENSE EXPENSES COVERAGE

A. *Feasibility*

The obligation to indemnify insureds for liability to third parties has been associated with the insurer's right to direct the insured's defense for so long that the two arrangements almost seem to be inextricably linked. However, there is no theoretical reason nor any public policy interest which requires liability insurers to provide insureds with a defense and clearly insurers are not obligated to include provisions which confer a right to defend. As the Third Circuit Court of Appeals observed in 1986, "the linkage between the duty to defend and the duty to indemnify is a creature of contract."⁷⁷ Some liability insurance policies either limit or eliminate the insurer's obligation to provide a defense.⁷⁸ Furthermore, in effect, the judicial decisions sustaining the rights of insureds to select independent counsel when there is a conflict of interests underscores the point that insurers do not have to be accorded a right to provide or to direct defenses for insureds.⁷⁹

76. The disputes between insurers and insureds sometimes extend beyond the adjudication in regard to whether an insurer is obligated to provide funding for an appeal following an adverse adjudication of a third party's claim. See R. KEETON & A. WIDISS, *supra* note 14, § 9.3(a)(5).

77. *Commercial Union Ins. Co. v. Pittsburgh Corning Corp.*, 789 F.2d 214, 218 n.5 (3d Cir. 1986).

78. Such provisions will be sustained by the courts when it is clear that the insured understands the nature of the arrangement. *Batdorf v. Transamerica Title Ins. Co.*, 41 Wash. App. 254, 702 P.2d 1211 (1985); *Commercial Union Ins. Co. v. Pittsburgh Corning*, 609 F. Supp. 685 (E.D. Pa. 1985). These forms have also been approved by state regulatory authorities.

79. See sources cited *supra* notes 54-55.

Nevertheless, there were and are pragmatic reasons for liability insurers to undertake the defense of an insured. Insurers obligated to indemnify an insured for liability to third parties are appropriately concerned about (1) the competence of attorneys representing insureds in the defenses to suits, (2) the adequacy of funds for defense expenses, (3) the possibilities for and terms of any proposed settlement of the claims against insureds, and (4) the strategies to be employed in the defenses of insureds in the event settlements are not worked out. However, severing the obligation to indemnify from the process of representing insureds in the settlement or adjudication of third party suits does not mean that those interests cannot be adequately protected.

1. *Assuring the Selection of Qualified Defense Attorneys*

Liability insurers are appropriately concerned with the qualifications and capabilities of attorneys who represent insureds in order to assure a vigorous and effective defense. One writer has observed that a potential disadvantage of allowing insureds to select independent defense counsel is that those attorneys will not possess the skills of "the defense 'regular' who performs with great skill" because "members of the insurance defense bar have built up a degree of skill and expertise in trial advocacy."⁸⁰ This should not be a significant problem. In general, it is reasonable to anticipate that most insureds would seek attorneys with expertise as trial counsel. Therefore, whether such differential skills — between the defense counsel selected by insurers and those that would be chosen by insureds — exist in the way contemplated by that observation is open to question. However, there are ample ways to build in safeguards to ensure that the defense is conducted by qualified counsel.

First, the selection of competent defense counsel could be assured by affording insurers the right to approve the attorney chosen by an insured.⁸¹ Moreover, whether defense counsel is selected by the insured or the insurer, both parties are certainly entitled to be fully informed about the attorney's handling of the case.⁸² Thus, even when defense counsel has not been selected by the liability insurer, the company will still be in a position to monitor the handling of the defense to the third party's suit and to raise questions if there is a failure to defend the insured's (and the insurer's) interests to the satisfaction of the insurer. Nevertheless, there may be some instances in which the proficiency of

80. Browne, *Postscript*, *supra* note 4, at 26. See also Berg, *Losing Control of the Defense — the Insured's Right to Select His Own Counsel*, July, 1984, *FOR THE DEFENSE*, at 10, 20.

81. See *Fireman's Fund Ins. Co. v. Waste Management of Wisconsin, Inc.*, 777 F.2d 366, 370 (7th Cir. 1985) (after noting that the district court had adopted the suggestion that independent counsel be selected by the insured subject to the approval of the insurer, the court observed, "There can be no more fair, sensible, and reasonable way for both parties to terminate the collateral dispute and to get on with the trial" of the tort claim than affording the insured the right to choose defense counsel subject to the insurance company's approval); see also *Tews Funeral Home, Inc. v. Ohio Casualty Co.*, 832 F.2d 1037, 1039 (7th Cir. 1987).

The California statute regulating the insured's right to independent counsel provides that "the insurer may exercise its right to require that the counsel selected by the insured possess certain minimum qualifications which may include that the selected counsel have (1) at least five years of civil litigation practice which includes substantial defense experience in the subject at issue in the litigation . . ." CAL. CIV. CODE § 2860(c) (West Supp. 1990). Also see *Centennial Ins. Co. v. Murat*, 206 Cal. App. 3d 1199, 253 Cal. Rptr. 914 (1989).

82. See, e.g., *infra* note 87 and accompanying statutory text.

defense counsel will not meet the insurer's expectations.⁸³ In order to protect against the possibility that an attorney (including one approved by the insurer) does not perform satisfactorily, the insurer should be afforded the right to require that an insured replace a defense counsel who is deemed to be unsatisfactory.⁸⁴

2. *Assuring Adequate Funding for the Defense*

By undertaking the defense of insureds, insurers were in a position to ensure that adequate funding — at least as adjudged by the insurer — would be available for the defense of the insured.⁸⁵ Guarantees of equally adequate funding are attainable by requiring an insurance purchaser to acquire specified minimum amounts of coverage for defense expenses. An apt analog for such an approach is the requirement generally imposed by insurers providing umbrella or excess coverage in regard to the requisite underlying (primary) insurance that must be acquired and maintained.⁸⁶ Alternatively, the liability coverage could be conditioned on prescribed minimum amounts of funding being available for defense expenses either from insurance or by the insured posting a bond when a suit is filed against the insured.

3. *Settlements*

When an insurer provides liability coverage without undertaking the defense, the insurer is still entitled to evaluate and approve any proposed settlement of claims which would involve the use of insurance funds. However, the selection and direction of defense counsel is not essential to affording an insurer a complete opportunity to assess settlement offers. For example, a California statute which establishes the right of insured to select defense counsel when there is a serious conflict of interests, includes several provisions which address this aspect of the relationship:

(d) When independent counsel has been selected by the insured, it shall be the duty of that counsel and the insured *to disclose to the insurer all information concerning the action except privileged materials relevant to coverage disputes, and timely to inform and consult with the insurer on all matters related to the action.* Any claim of privilege asserted is subject to in camera review in the appropriate law and motion department of the superior court.

. . .

83. The extent of such problems are likely to be quite small and in most instances subject to resolution without requiring the replacement of the defense attorney.

84. Replacement of the attorney is likely to involve some additional expenses which should be at least partially borne by the liability insurer which has requested the replacement.

85. This is a considerably less significant concern in regard to many individual and corporate entities that are financially responsible. Especially when a claim against the insured exceeds the coverage and the insured has the resources to finance a defense, self interest usually dictates that an effective defense will be arranged by the insured.

86. Given the communications and data handling capacity made possible by current technological systems, liability insurers can be fully apprised of the insured's compliance or failure to comply with the requirement for defense insurance coverage.

(f) Where the insured selects independent counsel pursuant to the provisions of this section, both the counsel provided by the insurer and independent counsel selected by the insured *shall be allowed to participate in all aspects of the litigation. Counsel shall cooperate fully in the exchange of information that is consistent with each counsel's ethical and legal obligation to the insured.*⁸⁷

It is not necessary to prescribe such obligations by statutory provisions. Essentially the same duties and rights can be — and, for the most part already are — imposed by the terms in liability insurance policies. Moreover, even in the absence of such terms, insurers would undoubtedly be entitled to be kept fully informed⁸⁸ about the handling of the case, including being apprised of all settlement possibilities and all information that relates to evaluating a possible settlement.

B. *Approaches to Severing Coverage for Defense Expenses*

1. *Judicial Actions, Legislative Actions, or Industry Actions*

In the absence of actions by the insurance industry, courts undoubtedly will continue to incrementally implement a partial severance of the obligation to indemnify from the provision of defenses for insureds. The judicial precedents sustaining the right of insureds to select independent counsel when a conflict of interests exists⁸⁹ represent significant steps along a road to complete abrogation of the insurers' role in the defense of suits against insureds. However, continuing this approach would be an extraordinarily expensive and inefficient path to follow. Moreover, the continual litigation of these disputes between insurers and insureds is likely to provoke legislative responses in additional states.⁹⁰ Statutes tend to create rigid solutions to problems which impede the ability of insurers to adapt both to changing conditions and to problems that may not have been understood, appreciated, or addressed in the course of the legislative process. Therefore, I believe it would be far more preferable for the insurance industry to take the initiative in developing approaches to separating the obligation to indemnify from the defense of insureds.

Approaches that could be employed by insurers to implement a severance of indemnification coverage from the arrangements associated with the defense of insureds include (1) independent defense counsel selected by the insured, but compensated by the liability insurer; (2) separate defense expenses insurance acquired from the same insurer that provides indemnification coverage; and (3)

87. CAL. CIV. CODE § 2860 (West Supp. 1990) (emphasis added). See also *United States Fidelity & Guar. Co. v. Superior Court*, 204 Cal. App. 3d 1513, 252 Cal. Rptr. 320 (1988).

88. It is conceivable that an attorney selected by the insured might attempt to protect the insured by withholding some information about the case from the insurer (such as evidence indicating the insured's acts were intentional). See Note, *supra* note 54, at 296; Comment, *Reexamining Conflicts of Interest: When is Private Counsel Necessary?*, 17 PAC. L.J. 1421, 1433 (1986). However, the prospects of such problems do not seem to be substantial.

89. See *supra* notes 54-55.

90. CAL. CIV. CODE § 2860 (West Supp. 1990) (adopted in 1987). The California legislation was undoubtedly developed, at least in part, in response to decisions by the California courts. See especially the widely discussed decision in *San Diego Navy Fed. Credit Union v. Cumis Ins. Soc., Inc.*, 162 Cal. App. 3d 358, 208 Cal. Rptr. 494 (1984).

defense expenses insurance acquired from another insurer. Each of these approaches would offer some advantages and disadvantages.

2. *Independent Defense Counsel Paid by the Liability Insurer*

The numerous judicial holdings requiring liability insurers to pay the legal expenses incurred by insureds who are allowed to select and direct defense counsel when there is a conflict of interests provide a model that could be applied generally to the selection of attorneys to represent insureds. In other words, liability insurance policies could provide (and some insurers already have at least partially embraced such an approach⁹¹) that the insurer would pay for defense counsel selected by the insured when a suit is filed by a third party. The significant advantages of this approach would be no need for an insured to arrange a separate insurance coverage for defense expenses and, consequently, no additional transaction costs for either the insured or the insurer.

Whether most liability insurers would deem it to be in their interest to undertake the obligation to pay defense expenses without being able to exercise control is doubtful. It seems unlikely that liability insurers will be willing to assume an unlimited obligation for defense expenses as part of the liability insurance arrangement without the right to direct the defense and to control the defense costs. Therefore, if insurers were to pursue this course, it would almost certainly evolve into a defense expenses insurance that would be included as a separate coverage.

3. *Separate Defense Expenses Insurance Provided by the Liability Insurer*

Liability insurers could include defense expenses insurance as an additional coverage, packaged with the liability insurance. Such insurance undoubtedly would be written with specific coverage limits. There are two notable disadvantages of this approach.

First, so long as defense expenses insurance is included as an additional coverage in specific types of liability insurance policies, the insurer's commitment for defense expenses coverage would almost certainly be related to the scope of the associated liability coverage. Consequently, there would be a substantial prospect for coverage gaps — that is, instances in which the obligation to provide coverage would not extend to the occurrence which produced the claim against the insured. For consumers, one of the significant lessons about insurance is the desirability of arrangements that are designed to avoid coverage gaps. Therefore, once defense insurance is conceived of as a separate coverage, most insureds would benefit from insurance policies that provide coverage for all types of negligence based suits that might be filed against the insured.⁹² In other words, the interests of many insureds would be better served by the acqui-

91. The insurance policy terms at issue in *New York State Urban Dev. Corp. v. VSL Corp.*, 738 F.2d 61, 65 (2d Cir. 1984), provided coverage for "Claims expenses" which were defined as including "fees charged by any attorney designated by [VSL] with the written consent of [Northbrook]" Excess and Surplus Insurance Company.

92. Alternatively, defense expenses insurance should at least be applicable for all types of occurrences for which the insured has acquired liability insurance.

sition of insurance which would provide comprehensive coverage for defense expenses rather than being "keyed" to a specific type of liability insurance.

Second, if defense expenses insurance were to be acquired as part of an "insurance package" from the liability insurer, it would not eliminate concerns about whether the insurers would really pursue a complete "hands off" policy. Certainly, an insurer providing defense expenses insurance would be entitled to information from and afforded many opportunities to discuss various matters with defense counsel. In the course of such discussions, the possibilities for either explicit or implied pressure that would influence decisions or actions by defense counsel are obvious. Consider the following comment by Ronald Mallen and Jeffrey Smith about the current relationships between insurers and defense counsel:

The attorney's relationship with the insurer is usually ongoing, supported by strong financial interest, and, like other long-term relationships, often strengthened by real friendships. In contrast, the attorney's relationship with the insured is usually transitory and limited to the defense of specific lawsuits.⁹³

Judges have made similar observations. For example, one of the California Court of Appeals decisions includes the following comment:

As a practical matter . . . there has been recognition that, in reality, the insurer's attorneys may have closer ties with the insurer and a more compelling interest in protecting the insurer's position, whether or not it coincides with what is best for the insured.⁹⁴

Essentially the same relationships between insurers and defense counsel would continue to exist if defense expenses insurance were included as a separate coverage in liability insurance policies. Thus, almost inevitably there would still be a sense or an appearance, if not the fact, of possible improprieties. Therefore, I think that the insurance industry, as well as the interests of individual insurers and insureds, would be best served by a complete separation.

4. *Defense Expenses Insurance Provided by a Different Insurer*

Abating the obligations and rights of liability insurers to provide defenses for insureds would create a market for defense expenses insurance, a type of coverage that would be comparable to medical expenses insurance. Millions of individuals purchase insurance that provides coverage for medical expenses. The analogy to defense expenses insurance is apt. Just as many medical expense insurance plans have been structured to afford comprehensive protection, defense expenses coverage could and should be designed to provide expansive protection for insureds.⁹⁵

93. R. MALLEN & J. SMITH, *supra* note 15, at 364-65 (footnote omitted).

94. *Purdy v. Pacific Auto. Ins. Co.*, 157 Cal. App. 3d 59, 76, 203 Cal. Rptr. 524, 534 (1984) (citing *U.S. Fidelity & Guar. Co. v. Louis A. Roser Co.*, 585 F.2d 932, 938 n.5 (8th Cir. 1978)).

95. Such coverage undoubtedly would be subject to some limitations. For example, there would probably be an evaluation designed to preclude coverage for defense expenses when an insured commits an outrageous intentional tort.

III. ADVANTAGES AND DISADVANTAGES OF DISASSOCIATING THE OBLIGATION TO INDEMNIFY INSUREDS FROM THE RIGHT OR DUTY TO PROVIDE A DEFENSE

A. *Potential Disadvantages*

Separating the obligation to indemnify from the defense of insureds could result in some disadvantages for insurers and insureds. The following discussion identifies several possibilities and suggests either some approaches which would avoid such consequences or reasons why postulated disadvantages probably will not be serious or significant.

Higher total premium charges. Acquisition of defense expenses insurance might⁹⁶ result in higher total premium charges for the liability coverages and defense expenses insurance than the premiums currently paid for comparable insurance policies which obligate the insurer to provide a defense.⁹⁷ However, there are several factors that may be sufficiently significant that such a differential will not exist. *First*, the cost of defense expenses coverage would be partially offset by lower premiums for liability insurance which would no longer include a significant cost component for defense expenses. *Second*, there may also be substantial savings from the elimination of the costs to insurers presently produced by many declaratory judgment actions, bad faith claims resulting from acts by the insurer in the course of settlement negotiations or litigation, and disputes over the scope of the obligation to provide a defense for insureds.⁹⁸ *Third*, for insurance purchasers who acquire several types of liability insurance, there would be some economies to be attained from the combining of the defense elements of different types of liability insurance into a single coverage.

Higher defense expenses: herein of monitoring and controlling costs. Some commentators have suggested that insureds would be charged more than insurance companies for defense work.⁹⁹ While this is a possibility, it is not an inevitable consequence of separating the obligation to indemnify from insurance for defense expenses. Insurers providing defense expenses insurance should be able to negotiate the same discounted rates that many liability insurers have heretofore been able to arrange with defense counsel. Although this is not certain, it is by no means beyond the range of the possible. Furthermore, insurers providing coverage for defense expenses could monitor lawyers — with a view to controlling costs — just as medical expenses insurers review health care providers. But even if there were an increase in the amounts paid to defense counsel, it would not disadvantage liability insurers. Rather, it would be an appropriate concern for consumers (in deciding whether to purchase coverage or how much

96. But also consider the discussion of possible lower costs in the following subsection.

97. *Additional acquisition burdens for purchasers.* One minor disadvantage that results from separating the obligation to indemnify is that most insurance purchasers would acquire separate insurance coverage for defense expenses. Thus, there would be some additional burden for consumers.

98. In general, a well designed comprehensive defense expenses insurance should not provoke as many disputes between insurers and insureds.

99. See, e.g., Browne, *Postscript*, *supra* note 4, at 26.

defense expenses coverage to acquire) and for insurers providing that coverage.¹⁰⁰

Complexity introduced by the involvement of two insurance companies. Another possible disadvantage would be the potential complexities introduced by the presence of two insurance companies, the indemnification insurer and the defense expenses insurer. Although both insurers would be concerned about the services to be rendered by attorneys on behalf of the insured, the focus of their respective areas of concern are very different. The role of a defense expenses insurer would be limited, much as is typically the case for a medical expenses insurer which reviews the reasonableness of the expenses incurred by the insured.

Loss of the liability insurer's expertise. Some insurers have developed considerable expertise in regard to the defense of claims against insureds. Although the role of the insurer in the defense would clearly be diminished when an insured selects independent defense counsel, that does not mean that all communications between the insurer and the insured or the defense attorney are precluded. Advice — including suggestions for various strategies — could (and should) still be tendered to defense counsel selected by an insured. And it would be foolhardy, as well as potentially negligent, for the attorney not to utilize suggestions from the insurer that serve the insured's interests.

Opportunities for the insured and independent counsel to structure the result of the litigation with the third party so as bring any judgment within the scope of the insurance coverage. There is a possibility that the insured's defense counsel, with or without the collaboration of the third party claimant, might be able to manipulate the resolution of issues in the tort suit so as to produce a judgment of liability that would be within the scope of the coverage. For example, one writer has commented:

If the insured is represented solely by counsel of his own choice — an attorney with neither ties nor obligations to the carrier — what is to prevent that counsel from so presenting the defense of the case as to establish coverage? . . . Indeed, it might well be argued that the insured's independent counsel would be doing less than his duty if no attempt was made to secure for the insured the protection afforded by the policy.¹⁰¹

These comments voice a legitimate concern about manipulations that might occur if the liability insurer were bound by the determinations explicitly or implicitly made by the resolution of the third party's claim.

In the past, some courts have decided that when an insurer was obligated to provide a defense or was afforded an opportunity to participate in an adjudication of the third party's claim against the insured, the insurer was bound by the resolution of issues in the tort suit when the insurer elected not to participate in that litigation. These precedents would not be on point were liability insurers to not be obligated to provide the insured's defense. When an insurer is

100. See *infra* note 107 and accompanying text.

One of the anomalies of separating the obligation to indemnify is that the interest of liability insurers in avoiding liability might cause those insurers to favor more extensive, and consequently more expensive, efforts on the part of defense counsel.

101. Browne, *Postscript*, *supra* note 4, at 24-25.

neither obligated to provide a defense nor involved in that litigation, there are compelling reasons — including the possibility of collusion between the insured and the third party — why the insurer should not be either bound by those determinations or estopped from raising coverage issues after the resolution of the third party's claim. If a liability insurer is not obligated to provide a defense, the requisite conditions for collateral estoppel or issue preclusion are not satisfied and, therefore, judicial precedents which apply those concepts to insurers would and should be readily distinguished in regard to insurers that only provide indemnification coverage.¹⁰² An insurer should not be bound by the results of the trial of the tort claim when it would deprive the insurer of any reasonable opportunity to contest coverage issues.¹⁰³

Disputes between the insured and liability insurer in regard to the management of the defense or the settlement of claims. When a defense attorney — whether selected by the insured or the insurer — works out a settlement proposal with a third party claimant, the proposal has to be submitted to the indemnification insurer for its approval. If the company approves, the settlement is consummated. However, insurers do not approve all proposed settlements which are agreeable to the third party, even when acceptance of the accord is urged by the insured. The introduction of defense expenses insurance undoubtedly will not eliminate all disagreements between insureds and liability insurers about the management of the defense or the settlement of claims. For example, there will continue to be circumstances when insureds would prefer to use the entire amount of the liability coverage to settle one or more claims (either for that amount or with an additional amount from the insured) and the insurance company will not view that as a sound decision. The insurance company should not be coerced into ratifying the insured's wishes. In my view, if the liability insurer does not approve a payment (up to its coverage limit), the defense to the third party claim should then be turned over to the insurer who would reap the benefits of a better settlement or judgment and would suffer the detriment of a judgment in excess of the proposed settlement or the coverage limits.¹⁰⁴

B. *Advantages*

Separating the obligation to indemnify insureds for liability to third parties from provisions for the defense against third party claims would:

- (1) avoid many conflict of interest problems;

102. See, e.g., *Farmers Ins. Co. v. Vaganuzzi*, 138 Ariz. 443, 675 P.2d 703 (1983).

103. In some cases, this would mean that the resolution of a tort claim in favor of the third party may be followed by an adjudication of coverage questions. However, this is no different from the separate resolution of such issues which often occur in either a declaratory judgment proceeding or a suit following the determination of the tort claim against the insured.

104. This approach would be comparable to the provisions in some medical malpractice insurance policies that provide for the approval of any settlement by the insured and, in the event an insured does not consent to a proposed settlement, which then authorize the insurer to discharge its obligation to the insured by then tendering the amount of the settlement to the insured. The approach suggested in the text could be very controversial. However, it is not essential to the introduction of defense expenses insurance that would be provided by a second insurer. An alternate, and undoubtedly less controversial approach would require the acquiescence of the liability insurer to any settlement. Only a bad faith decision not to approve would shift the risks to the insurer.

- (2) eliminate several classes of disputes which have produced an increasing volume of litigation between insurers and insureds, including
 - (a) questions in regard to whether and when the scope of the obligation to defend is more extensive than the obligation to indemnify;
 - (b) questions about whether and when there is an obligation to defend following the exhaustion of coverage limits;
 - (c) questions about whether an insurer is obligated to initiate an appeal following an adjudication of a court or arbitrator;
- (3) eliminate the indeterminacy in regard to the amount of defense expenses that are covered by the insurer;
- (4) afford many insureds an opportunity to arrange more extensive and comprehensive coverage for defense expenses; and
- (5) possibly result in lowering the costs of acquiring defense expenses insurance for many purchasers as a consequence of combining coverage for the defenses of all types of liability claims.

Conflict of interests. The vast majority of conflict of interest problems simply would not exist were liability insurers not to provide the defenses for the insureds. For example, there would be virtually¹⁰⁵ no reasons for a liability insurer to issue a reservation-of-rights or to request an acceptance of a non-waiver agreement. Issues related to providing the defense for two insureds would never occur. Questions about whether a particular occurrence was or was not covered would not affect the direction of a defense counsel by the insurer (although such issues might still have to be resolved between the insured and the insurer in order to determine whether the insurance coverage was available for a settlement).

Elimination of disputes about the relation of the liability coverage to the defense obligation. Obviously, separating the defense obligation would mean that there would be no disputes with a liability insurer about the nature and scope of the obligation to provide a defense. Questions about the relationship of the defense obligation as a function of the indemnification obligation would not arise because there would be no reason to condition defense expenses insurance on the nature or extent of the liability insurer's obligations. Similarly, when indemnification coverage is separated from defense expenses insurance, by definition there would be no relationship between the two obligations. Each insurer's obligation to the insured would continue until the applicable coverage limits were exhausted.

Elimination of indeterminacy about the amount of defense expenses that will be paid by an insurer. Liability insurance policies do not provide insureds with any indication of how much the insurer will spend on costs that may be incurred in the defense of the insured. Apparently, some insurers are parsimoni-

105. In some circumstances, insurers might still deem it advisable to employ such notices or agreements during the phases of claims process that precede the initiation of a law suit against an insured.

ous when it comes to spending money for the defenses of insureds.¹⁰⁶ Moreover, many insurers have adopted the view that the company is free to tender the coverage limits and thereby terminate the obligation to expend any funds for the defense of insureds. Other insurers have concluded that the defense obligation terminates when the coverage limits are exhausted by settlements or by judgments secured by some of the third party claimants. The indeterminacy of the obligation is, at best, unsettling for insureds who are aware of these possibilities. Moreover, in some circumstances there is only an illusion of an obligation for the insurer to incur these costs. Arrangements for a fixed amount of defense expenses insurance are clearly to be preferred over the present approach which may only afford an insured the possibility that the insurer is obligated to incur these expenses or to provide indemnification for such expenses.

More extensive and comprehensive coverage. The introduction of separate defense expenses insurance will allow purchasers to make informed decisions about the nature and amount of the coverage they want to acquire for defense expenses. Moreover, the market place should — and, if necessary, insurers could be required to — afford consumers choices about how much defense expenses coverage to acquire.¹⁰⁷

Lower combined costs for defense expenses insurance. Consumers frequently purchase more than one liability insurance coverage. For example, many individuals acquire separate liability insurance policies for risks incident to home ownership, operating automobiles, and the use of recreational equipment (motorcycles, boats, snow mobiles, aircraft, etc.). Furthermore, individuals who own rental property — either residential or commercial — usually acquire additional liability insurance policies for those risks. Similarly, businesses frequently acquire several different liability insurance policies. When these liability coverages provide for the defense of the insured(s), each insurer underwrites the risks of defense costs (frequently without any coverage limit save for the possibility that the insurer may be free to decide that its interests would be served by disbursing the applicable coverage as quickly as possible when the defense costs are likely to be substantial, particularly when defense costs would exceed the coverage limits). Therefore, it is possible that acquiring a single insurance policy for defense expenses — with fixed coverage limits for each occurrence — would be at least as efficient and no more costly than the current approach. It might even produce lower net premium costs.

106. As noted in the discussion of conflict of interests, when the obligation to indemnify is coupled with the defense of the insured, the insurance company may be inclined to minimize the defense expenses. Several years ago, Professor Browne observed that a liability insurer may be tempted "to make every effort to keep the costs of defense as low as possible." Browne, *Postscript*, *supra* note 4, at 25. In response to what has been described as a "classic case of inadequate preparation due to cost constraints," Judge Knapp concluded, "[W]hatever its motives, the record before us makes clear that the carrier deliberately decided not to spend the funds necessary to give this particular assured the semblance of a defense." *Bevevino v. Saydjari*, 76 F.R.D. 88, 93 (S.D.N.Y. 1977) quoted in Cooney, *The Perils of Defense Counsel's Relinquishment of Control Over Preparation of the Defense to the Insurer*, 52 INS. COUNS. J. 259, 261 (1985).

107. Regardless of how much coverage is acquired, there would still be a possibility that the defense expenses insurance would be exhausted. In that case, the liability insurer and the insured would have to agree on how to proceed. It is conceivable that the liability insurer could agree to provide funds to continue the defense, thereby creating a situation comparable to that which now exists when an insured selects independent defense counsel.

IV. CONCLUSION

The justifications for disassociating insurance arrangements that indemnify insureds for liability from both (a) the right of a liability insurer to control the defense of insureds and (b) the duty of a liability insurer to provide defenses for insureds, rests on the many difficulties and disputed matters that are repeatedly encountered by insurers and insureds when claims by third parties are not resolved without recourse to lawsuits. Foremost among these problems are numerous conflicts of interests. Whenever there is a suit by a third party claimant, conflicting interests — both potential and actual — pervade the relationship between liability insurers and insureds. Consequently, a liability insurer or a defense counsel selected by an insurer should almost always advise an insured to consult with an independent counsel. Moreover, in my view, after an insured has consulted an independent counsel, an insurance company is well advised to accede to a request that the insurer provide funding for a defense that will be undertaken by an attorney to be selected by the insured.

There is now a very substantial body of judicial precedents — as well as at least one state statute — which sustain the right of insureds to select and direct defense counsel, who are then paid by the liability insurer, when there is a significant conflict of interests between the insurer and the insured. Thus, courts have imposed the type of separation proposed herein for some situations. I believe that the case is now very compelling for *always* separating insurance coverage which indemnifies insureds for their liability to third parties from insurance arrangements that either indemnify insureds for defense expenses or obligate insurers to provide a defense.

Defense expenses insurance coverage would both facilitate the separation of the obligation to defend from the obligation to indemnify *and* circumvent most conflict of interest problems. In addition, separation would also eliminate disputes about whether an insurer is obligated to provide a defense when a third party's claim may not be covered by a particular liability insurance policy or when the coverage limits have been exhausted (by one or more settlements, by a tender of the coverage limits, or by the payment of one or more judgments). Furthermore, another significant benefit of the separation is that it should result in virtually the complete elimination of suits by insureds against liability insurers that are predicated on assertions that an insurer acted in bad faith in the course of representing the insured in the defense to a third party's suit. The grounds for most of the suits by insureds against liability insurers alleging acts of bad faith and unfair dealing — coupled with claims for coverage in excess of policy limits, consequential damages, and punitive damages — which have proliferated in the past twenty years, simply would not exist.

As the expenses incident to defending tort claims have increased, this aspect of the liability insurance arrangement has become and is likely to continue to be a matter of very substantial concern for both insurers and insureds. Insureds would clearly benefit from insurance which would provide coverage for defense expenses whenever a suit is predicated on negligent acts. The time has arrived to treat defense expenses as a distinct group of risks that should be separately underwritten and marketed to the public.

